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REGULATION OF INTERMODAL RATE COMPETITION IN TRANSPORTATION

Joseph R. Rose*

PERSISTENT efforts by railroads to reduce the control exercised by the Interstate Commerce Commission (Commission) over rates applicable to competition among different modes of transport have precipitated perhaps the most acrimonious controversy in transport regulation since World War II. The railroads have vigorously pressed their arguments on the Commission, the courts, and the Congress. They have had the support of two Presidents,¹ two Secretaries of Commerce,² the Department of Transportation,³ and the weight of academic opinion.⁴ Yet thus far they have failed to effect a change in either the Commission's policy or the law governing it; and the Supreme Court has twice dealt inconclusively with the issues.⁵

The controversy over intermodal rate competition comprehends both legal and economic issues. Clarity requires that each be explicitly stated and separately treated. The legal issues center on the meaning of section 15a(3) of the Interstate Commerce Act⁶ and

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1. MESSAGE FROM THE PRESIDENT OF THE UNITED STATES RELATIVE TO THE TRANSPORTATION SYSTEM OF OUR NATION, April 5, 1962, H.R. Doc. No. 384, 87th Cong., 2d Sess. (1962); ECONOMIC REPORT OF THE PRESIDENT, H.R. Doc. No. 348, 89th Cong., 2d Sess. 124 (1966); ECONOMIC REPORT OF THE PRESIDENT, H.R. Doc. No. 28, 91st Cong., 1st Sess. 112 (1969).

2. PRESIDENTIAL ADVISORY COMMITTEE ON TRANSPORT POLICY AND ORGANIZATION, REVISION OF FEDERAL TRANSPORTATION POLICY (1955) (Weeks Report); U.S. DEPT. OF COMMERCE, FEDERAL TRANSPORTATION POLICY AND PROGRAMS (1960) (Mueller Report).

3. Statements submitted by Paul N. Cherington, Assistant Secretary for Policy and International Affairs, and his successor Charles D. Baker on January 30 and April 30, 1970, respectively, before the Interstate Commerce Commission (ICC or Commission) in Rules To Govern the Assembling & Presenting of Cost Evidence, 337 I.C.C. 298 (1970) [hereinafter Docket No. 34013].

4. See, e.g., Baumol, *et al.*, *The Role of Cost in the Minimum Pricing of Railroad Services*, 35 U. CHI. J. BUS. 357 (1962) [hereinafter Baumol]; Baumol, *et al.*, *Statement of Clarification*, 36 U. CHI. J. BUS. 348 (1963) [hereinafter Baumol, *Clarification*]. Both of these publications were prepared jointly by ten academic economists under the auspices of the Association of American Railroads.

5. *American Commercial Lines, Inc. v. Louisville & N.R.R.*, 392 U.S. 571 (1968) [hereinafter *Ingot Molds*]; *ICC v. New York, N.H. & H.R.R.*, 372 U.S. 744 (1963) [hereinafter *New Haven*].

6. 49 U.S.C. § 15a(3) (1964), formerly Pub. L. No. 85-625, § 6, 72 Stat. 572 (1958). For studies prior to 1958, see E. WILLIAMS, *THE REGULATION OF RAIL-MOTOR RATE*

the declaration of the National Transportation Policy that precedes the Act,⁷ which are the sources of the Commission's authority. The economic issues involve the effect on resource allocation of rate-making proposals devised to carry out these provisions of the Act.

I. THE LEGAL ISSUES

Section 15a(3), added to the Interstate Commerce Act in 1958, states that "[i]n a proceeding involving competition between carriers of different modes of transportation subject to this Act, the Commission, in determining whether a rate is lower than a reasonable minimum rate, shall consider the facts and circumstances attending the movement of the traffic by the carrier . . . to which the rate is applicable" and that "[r]ates of a carrier shall not be held up to a particular level to protect the traffic of any other mode of transportation, giving due consideration to the objectives of the national transportation policy declared in this Act."⁸ The National Transportation Policy provides, *inter alia*, for the

fair and impartial regulation of all modes of transportation subject to the . . . Act, so administered as to recognize and preserve the inherent advantages of each; . . . all to the end of developing, coordinating, and preserving a national transportation system by water, highway, and rail, as well as other means adequate to meet the needs of the commerce of the United States, of the Postal Service, and of the national defense.⁹

COMPETITION (1958); Bigham, *Regulation of Minimum Rates in Transportation*, 61 Q.J. ECON. 173 (1947).

7. 49 U.S.C. preceding § 1 (1964) (originally enacted as Act of Sept. 18, 1940, ch. 722, tit. I, § 1, 54 Stat. 899).

8. 49 U.S.C. § 15a(3) (1964). Section 15a(3) applies only to competition among regulated modes; it does not apply to competition between regulated and unregulated carriers. *American Commercial Lines, Inc. v. Louisville & N.R.R.*, 392 U.S. 571, 593 (1968). Rate-making, when the competing carrier is unregulated, is governed by § 1(5) of the Act, which provides that rates shall be "just and reasonable." A just and reasonable rate is "compensatory" (*Limestone in Trainloads from Prairie du Rocher, Ill. to Baton Rouge, La.*, 313 I.C.C. 71, 86 (1960)), which means that it must be in excess of "out-of-pocket" cost (*ICC v. New York, N.H. & H.R.R.*, 372 U.S. 744, 748 (1963)). See note 18 *infra*. The Commission has stated, "While rates which exceed out-of-pocket costs by only slight margins have been approved when required by special circumstances, the Commission has never taken the view that any particular margin must be set. Logic dictates that each rate must be judged in light of the facts and circumstances surrounding it." *Sea-Land Serv., Inc. v. New York Cent. R.R.*, 329 I.C.C. 589, 596 (1967). For illustrations of "special circumstances," see *Grain in Multiple-Car Shipments—River Crossings to the South*, 318 I.C.C. 641, 684, *revd.*, 321 I.C.C. 582 (1963), *revd. sub nom.* *Cincinnati, N.O. & T.P. Ry. v. United States*, 229 F. Supp. 572 (S.D. Ohio 1964), *vacated and remanded sub nom.* *Arrow Transp. Co. v. Cincinnati, N.O.T.P. Ry.*, 379 U.S. 642, *affd. on remand*, 325 I.C.C. 752 (1965); *Coal from Southern Mines to Tampa and Sutton, Fla.*, 318 I.C.C. 371, 386 (1962).

9. 49 U.S.C. preceding § 1 (1964).

The Supreme Court, construing section 15a(3) for the first time in *ICC v. New York, N.H. & H.R.R. (New Haven)*,¹⁰ declared that the principal reason for the reference in that section to the National Transportation Policy "was to emphasize the power of the Commission to prevent the railroads from destroying or impairing the inherent advantages of other modes,"¹¹ and it decided that the "initial determination" of which mode had the inherent advantages must be made by the Commission.¹² The Act does not define "inherent advantages"; in *New Haven* the Court casually mentioned "cost and service" advantages but failed to define those terms.¹³ The concept of "service advantage" has occasioned little controversy,¹⁴ but the search for the proper definition of "cost advantage" now constitutes the basic legal issue in proceedings under section 15a(3).

A. The Commission's Policy

According to the Commission, service advantage is measured by comparing shipper costs associated with particular transport services.¹⁵ Shipper costs include such expenses as are incurred by shippers for loading, unloading, drayage, and breakage; they also include inventory costs, which are often their most important ingredient. The Commission regards the carrier that requires the smaller shipping costs as the mode of transport with the service advantage.¹⁶

Cost advantage, on the other hand, is derived by comparing carrier costs of the competing modes of transport;¹⁷ and the recurring legal controversy has centered on determining the proper method of measuring carrier cost for use in the comparative equation. The

10. 372 U.S. 744 (1963).

11. 372 U.S. at 758.

12. 372 U.S. at 763-64.

13. 372 U.S. at 755-56, 759.

14. The concept of service advantage is not directly relevant to the task of rate-making. Service advantage is for practical purposes a demand factor, with which the regulatory authority should not concern itself in determining inherent advantage. If rates reflect differences in carriers' marginal costs (*see* notes 70 & 71 *infra* and accompanying text and pt. II. B. 2. *infra*), and shippers select the mode that minimizes their total transport costs, traffic tends to be economically allocated.

15. Fresh Meats, Transcontinental, Westbound, 309 I.C.C. 529, 535, 544 (1960); Tobacco from North Carolina to Central Territory, 309 I.C.C. 347, 353 (1960). The Commission found service differences between two modes minimal in Motor Vehicles from Kansas City to Arkansas, Louisiana & Texas, 318 I.C.C. 301, 319-20 (1962). *See also* J. MEYER, M. PECK, J. STENASON & C. ZWICK, *THE ECONOMICS OF COMPETITION IN THE TRANSPORTATION INDUSTRIES* 189-90 (1959).

16. Cement within Southern Territory & from Hagerstown, Md., to the South, 319 I.C.C. 465, 471, 475 (1963).

17. Ingot Molds, Pa. to Steelton, Ky., 326 I.C.C. 77, 83 (1965). *See also* Docket No. 34013, *supra* note 3.

Commission has generally used fully distributed costs rather than out-of-pocket costs as the appropriate standard¹⁸ and has regarded the carrier with the lower fully distributed cost as the mode with the cost advantage.¹⁹

18. "Out-of-pocket" and "fully distributed" costs were the terms employed by the ICC until its disposition of the rule-making proceeding in Docket No. 34013, *supra* note 3. In that proceeding, the Commission decided to substitute for that terminology "variable" and "fully allocated" costs respectively, which were given slightly different meanings.

Out-of-pocket costs included "80% of freight operating expenses, rents and taxes (excluding Federal income taxes) plus a return of 4 percent after Federal income taxes on 50 percent of the road property and 100 percent of the equipment used in freight service." ICC, BUREAU OF ACCOUNTS STATEMENT No. 2-68, RAIL CARLOAD COST SCALES BY TERRITORIES FOR THE YEAR 1966, at 4 (1968). The Commission regarded 80% as the measure of cost variability (elasticity). *Id.* For an explanation of the procedure to determine variability, see ICC, BUREAU OF ACCOUNTS STATEMENT No. 7-63, EXPLANATION OF RAIL COST FINDING PROCEDURES AND PRINCIPLES RELATING TO THE USE OF COSTS ch. 2 (1963). Fully distributed costs included "in addition to the out-of-pocket costs as described above, all other revenue needs necessary to permit the carriers to cover the remaining 20 percent of the freight operating expenses, rents, and taxes, the passenger-train and less-carload operating deficits and a return of 4 percent after Federal income taxes on the remaining property." STATEMENT No. 2-68, *supra* at 4.

In Docket No. 34013, the Commission, *inter alia*, adopted new cost terminology. It found that "[t]he terms 'out-of-pocket costs' and 'fully distributed costs,' as used in Commission proceedings, should be changed to 'variable costs' and 'fully allocated costs,' respectively, and the noncost elements of profit, income taxes, and for railroads, the passenger and less-than-carload deficits, should be excluded therefrom." 337 I.C.C. at 326. The Commission also made a change in the determination of the "variability factor." It found that "[t]he determination of a variability factor for particular services requires the selection of an appropriate time period which is sufficiently long to reflect adequately those changes in operations resulting in expenses which can reasonably be expected to vary with the performance of the particular service or services rendered." 337 I.C.C. at 326.

It should be noted that the Commission in this rule-making proceeding explicitly refused to adopt any criterion of inherent cost advantage. The Examiner had recommended that "(7) inherent cost advantages should generally be protected through the approval of prescription of rate differentials, measured by the difference between the respective fully allocated cost levels of competing modes of transportation, when the involved rates are shown to be below such levels." Docket No. 34013, *Examiners' Recommended Report and Order 123* (Oct. 10, 1966). The Commission declared that it would consider "matters relating to recommended finding No. 7 (dealing with inherent cost advantages as between competing modes)" in related proceedings in *Cost Standards in Intermodal Rate Proceedings*, Docket No. 34013 (Sub-No. 1), which will be the subject of a separate report. 337 I.C.C. at 301. The latter proceeding was not initiated until February 5, 1969, almost seven years after the inception of Docket No. 34013 and more than six months after the decision in *Ingot Molds*. In that case, the Supreme Court refused to decide the issue of cost advantage until the Commission made an "initial determination," which the Court obviously expected in Docket No. 34013. See notes 52-54 *infra* and accompanying text.

19. In the absence of evidence of fully distributed costs, the Commission has used out-of-pocket costs as the measure of cost advantage. Automobile Lamps & Alcoholic Liquors, Pennsylvania to Texas & Louisiana, 319 I.C.C. 335, 338 (1963). For a full discussion of the Commission's conception of cost advantage, see Grain in Multiple-Car Shipments—River Crossings to the South, 321 I.C.C. 582, 596-604 (1963), *modified on other grounds*, 325 I.C.C. 752 (1965) (discussed in note 8 *supra*). The Commission decided that in determining "inherent" cost advantage, public expenditures on the domestic-waterway system should not be attributed to the water carriers.

In proceedings involving railroad rates reduced to meet the competition of water carriers, the evidence typically shows that water carriers have the cost advantage and railroads have the service advantage.²⁰ In cases that involve competition between railroads and motor carriers, the evidence usually shows that when the railroad service is performed by conventional freight cars the railroads have the cost advantage and the motor carriers have the service advantage;²¹ when railroad service involves such improved facilities as trailer-on-flat cars (TOFC), however, cost and service advantages may be equally divided between the two modes.²²

Before *New Haven*, the Commission did not commonly make an explicit "initial finding" of inherent advantage in proceedings under section 15a(3). Its policy, generally, was to maintain railroad minimum rates at a level that enabled regulated water and motor carriers to compete with railroads at rates covering the nonrail carriers' fully distributed costs.²³ Railroad rates below such a minimum were condemned by the Commission as "destructive competition" even when they exceeded the railroads' fully distributed costs.²⁴ Thus, railroad rates were required to be differentially above the approved rates of competing water carriers—that is, above the water carriers' fully distributed costs;²⁵ similarly, the Commission approved railroad rates

20. See, e.g., *American Commercial Lines, Inc. v. Louisville & N.R.R.*, 392 U.S. 571, 575-76 (1968).

21. See, e.g., *Tobacco from North Carolina to Central Territory*, 309 I.C.C. 347, 353 (1960). Occasionally, however, the Commission finds the service advantages equally divided between rail and motor. *Exceptions Ratings on Agricultural, Roadmaking, and Other Articles*, 315 I.C.C. 9, 14 (1961), *revd. on other grounds sub nom. Missouri Pac. R.R. v. United States*, 203 F. Supp. 629 (E.D. Mo. 1962).

22. See, e.g., *Motor Vehicles from Kansas City to Arkansas, Louisiana & Texas*, 318 I.C.C. 301, 319 (1962). Service differences were there found to be minimal, but trailer-on-flat-car [hereinafter TOFC] rail service had the lower costs. In rate-making proceedings, motor carriers often fail to introduce evidence of their costs. *Paint & Related Articles in Official Territory*, 308 I.C.C. 439, 448 (1959).

23. *Commodities—Pan-Atlantic S.S. Corp.*, 313 I.C.C. 23, 49 (1960) [hereinafter *Pan-Atlantic*], *revd.*, *New York, N.H. & H.R.R. v. United States*, 199 F. Supp. 635 (D. Conn. 1961), *remanded to ICC*, *ICC v. New York, N.H. & H.R.R.*, 372 U.S. 744 (1963).

24. 313 ICC at 47. See also note 25 *infra*.

25. In *Pan-Atlantic*, the leading case, the ICC condemned as destructive competition railroad rates that had been reduced to the level of competing coastwise water carrier rates. Although there was evidence of record to support a finding of cost advantage in favor of the coastwise water carriers, the Commission did not make such a finding. All of the railroad rates were compensatory and most of them were above fully distributed costs. The ICC declared that, under the circumstances, the railroad rates should be 6% higher than the competing water rates. 313 I.C.C. at 50.

Before *Pan-Atlantic*, the Commission had rarely found railroad rates unlawful under § 15a(3). It distinguished the earlier cases from *Pan-Atlantic* on the ground that in those cases the reduced rates did not threaten to cause successive rate reductions—that is, rate wars. The ICC cited the following proceedings in which it had approved reduced railroad rates, whether the rates covered fully distributed costs or

differentially below the rates or fully distributed costs of competing

merely out-of-pocket costs: Magnesium from Velasco, Tex. to East St. Louis, Ill., 309 I.C.C. 659 (1960), *revd.*, 306 I.C.C. 45 (1959); Lumber from California & Oregon to California & Arizona, 308 I.C.C. 345 (1959); Paint & Related Articles in Official Territory, 308 I.C.C. 439 (1959); Sugar to Ohio River Crossings, 308 I.C.C. 167 (1959), *revd.*, 315 I.C.C. 521 (1962), *affd. on rehearing*, 319 I.C.C. 782 (1963). The Commission also had approved reduced railroad rates in Export Soybeans from Southwest & South to Gulf Ports, 309 I.C.C. 445 (1960) (in which the reduced railroad rates were compensatory but greatly in excess of competing barge rates); Pig Iron from Ashland, Ky., to Kansas City, Mo., 310 I.C.C. 641 (1960), (in which some of the reduced railroad rates covered fully distributed costs and others were merely compensatory); and Paper from St. Francisville, La. to Chicago, Ill., 306 I.C.C. 703 (1959) (no differential above water rates required because of the high level of both rail and water rates). *See also* Iron or Steel Slabs from Cincinnati, Ohio & Newport, Ky. to Riverdale, Ill., 308 I.C.C. 151 (1959); Synthetic Resin from New York Area, 305 I.C.C. 5 (1958); Tinplate from St. Louis Group to Texas, 304 I.C.C. 473 (1958). In Roofing or Siding from the Twin Cities to South Dakota, 308 I.C.C. 278 (1959), the Commission approved "fully compensatory" motor rates below the competing railroad rates; and in Class Rates from Chicago, Ill. to Texas, 308 I.C.C. 467 (1958), it held compensatory freight forwarder and motor carrier rates lawful under § 15a(3).

Only one pre-*Pan-Atlantic* case was found in which the Commission disapproved railroad rates under § 15a(3). In Tobacco from North Carolina to Central Territory, 309 I.C.C. 347 (1960), railroad rates covering fully distributed costs were held unlawful on the ground they would reduce earnings on high-grade traffic.

After *Pan-Atlantic*, the Commission did not again discuss § 15a(3) at length until *Various Commodities* from or to Arkansas & Texas, 314 I.C.C. 215 (1961). The material facts of *Various Commodities* were similar to those in *Pan-Atlantic*, except that the coastwise water carriers did not present evidence of their costs. The Commission approved the reduced railroad rates, holding that they could not be considered destructive competition in the absence of cost evidence. It is noteworthy that the railroad rates in *Various Commodities* were merely compensatory while those in *Pan-Atlantic* for the most part covered fully distributed costs. But following *Pan-Atlantic*, the Commission generally continued to reject reduced railroad rates regardless of cost advantage. Paint or Varnish Driers from East to Southwest, 313 I.C.C. 719, 722 (1961) (railroad rates required to be somewhat less than 6% above water rates because the railroad service was performed with box cars rather than TOFC as in *Pan-Atlantic*); Pig Iron from Neville Island, Pa. to Louisville, Ky., 313 I.C.C. 771, 779 (1961), *revd.*, *Pennsylvania R.R. v. United States*, 202 F. Supp. 584 (E.D. Pa. 1962) (ICC disapproved a railroad rate below the total cost to the shipper of using a competing rail-water-rail service and required the railroad rate to be equal to such total cost). In only one proceeding during this period did the Commission, in holding a competing railroad rate unlawful, make a finding of cost advantage in favor of a water carrier. In *Newsprint Paper* from Tennessee & Alabama to Houston, Tex., 313 I.C.C. 669, 674 (1961), the Commission required a railroad rate to exceed the water carrier's fully distributed costs by 10%. In *Electric Wire & Cable* from Eastern Origins to Texas, 314 I.C.C. 71, 74 (1961), the Commission condemned the railroad rate with the statement that "the evidence is convincing that Seatrain [the water competitor] is the low cost carrier," but established no differential in its favor.

Even after *Various Commodities*, the Commission persisted in following *Pan-Atlantic* and in condemning railroad rates as destructive competition without findings of cost advantage. Agricultural Insecticides in Tank Cars from Heyden, N.J. to Houston, Tex., 315 I.C.C. 623 (1962), *revd.*, 319 I.C.C. 493 (1963); Sugar from the South to Indiana, Ohio River & Intermediate Points, 315 I.C.C. 521 (1962), *revd.*, 319 I.C.C. 782 (1963); Plastics from Texas to the East, 314 I.C.C. 347 (1961), *revd.*, 319 I.C.C. 379 (1963); Commodities in Trailers on Flatcars, East to Texas, 314 I.C.C. 423 (1961); DDT from Avon, Pa. to Points in Texas, 314 I.C.C. 453 (1961), *revd.*, 319 I.C.C. 431 (1963); Garden Hose & Electric Cable from New Jersey or Rhode Island to Points in Texas, 314 I.C.C. 515 (1961), *revd.*, 319 I.C.C. 227 (1963); Cereal, Coffee, Tea, Drugs, Related Articles from New Jersey & Pennsylvania to Texas, 314 I.C.C. 734 (1961), *revd.*, 319

motor carriers.²⁶ The differential in the former case was to be large enough to compensate for the railroads' service advantage and in the latter just low enough to compensate for the motor carriers' service advantage.

The Commission based its policy of maintaining the rates of water and motor carriers at the level of fully distributed costs on those carriers' need to recover such costs in order to continue their opera-

I.C.C. 424 (1963); Electric Cable & Wire from Worcester, Mass. to Houston, Tex., 314 I.C.C. 743 (1961), *revd.*, 319 I.C.C. 390 (1963). The Commission condemned reduced railroad rates on the ground that they would dissipate needed revenues on high-value traffic. Pig Iron from Buffalo, N.Y. to Chicago, Ill. & Gary, Ind., 315 I.C.C. 601 (1962); Alcoholic Liquors from New Hampshire & New York to Texas & Louisiana, 315 I.C.C. 124 (1961), *revd.*, 319 I.C.C. 396 (1963). The reversals by the Commission came after the Supreme Court's decision in *New Haven*.

Various Commodities was first cited in Canned Goods from Eastern Points to Pacific Coast, 315 I.C.C. 757, 761 (1962), in which the Commission said the evidence must show "which is the low cost mode" in order to sustain a claim of destructive competition. Thus, reduced railroad rates were approved in the absence of evidence showing the protestant to be the low-cost mode in Wool from Norfolk & Newport News, Va. to Charleston, S.C., 316 I.C.C. 109 (1962); Newsprint Paper from Tennessee & Alabama to Baton Rouge, La., 315 I.C.C. 117 (1961). Compensatory railroad rates were upheld in Canned or Preserved Foodstuffs from Pacific Coast to Gulf Ports for Export, 314 I.C.C. 569 (1961), without discussion of cost advantage, for situations where the railroad rates would have no material effect on competing water carriers. Similarly, compensatory railroad rates were approved without mention of *Various Commodities* in Canned Goods from Pacific Coast to Eastern Points, 315 I.C.C. 769 (1962). In Phosphate Rock from Florida to Southwestern & Western Trunkline Territories, 316 I.C.C. 207 (1962), the Commission approved compensatory railroad rates where the railroad had the cost advantage on some routes and the competing rail-motor-rail service had the cost advantage on others.

26. For a clear demonstration of the Commission's method, see Fresh Meats, Transcontinental, Westbound, 309 I.C.C. 529 (1960). In these early cases, the Commission disapproved railroad rates when it found "destructive competition" even if the rail rates covered fully distributed costs. See, e.g., Cigars from Jacksonville to Kansas City, 313 I.C.C. 633 (1961), *revd. sub nom.* St. Louis-San Francisco R.R. v. United States, 207 F. Supp. 293 (E.D. Mo. 1962); Exceptions Ratings on Agricultural, Roadmaking, and Other Articles, 315 I.C.C. 9 (1961), *revd. sub nom.* Missouri Pac. R.R. v. United States, 203 F. Supp. 629 (E.D. Mo. 1962); Tobacco from North Carolina to Central Territory, 309 I.C.C. 347 (1960).

Prior to *New Haven*, however, the Commission generally approved railroad rates that had been reduced to meet motor-carrier competition. Synthetic Resin from New York Area, 305 I.C.C. 5 (1958). In Gasoline & Fuel Oil from Friendship, N.C. to Virginia & West Virginia, 305 I.C.C. 673 (1959), the Commission approved railroad rates, covering fully distributed costs, that were calculated to divide the traffic with motor carriers whose rates also covered fully distributed costs. But the agency also approved compensatory railroad rates when the evidence indicated that motor carriers could compete at their existing rates. See, e.g., Paint and Related Articles in Official Territory, 308 I.C.C. 439 (1959). After *Various Commodities*, compensatory rates for TOFC service were approved when both railroads and motor carriers failed to offer evidence of fully distributed costs. Meats, Fruits, Vegetables—TOFC—Transcontinental, 316 I.C.C. 585 (1962). And compensatory TOFC rates were upheld although they threatened to divert traffic from competing motor carriers. Motor Vehicles from Kansas City to Arkansas, Louisiana & Texas, 318 I.C.C. 301 (1962). See also *Middlewest Motor Freight Bureau v. Great Northern R.R.*, 316 I.C.C. 443 (1962); *Eastern Cent. Motor Carriers Assn., Inc. v. Baltimore & O.R.R.*, 314 I.C.C. 5 (1961). Thus, the Commission appeared to encourage the TOFC service.

tions. A railroad ordinarily serves numerous markets. In some markets the demand for railroad services is relatively inelastic and a rail carrier is thus able to maintain rates at a level substantially above full costs. Absent regulation, therefore, a railroad can afford to cut rates below its full cost in those markets in which it encounters intermodal competition and in which the demand for its services is relatively elastic, because these losses can be recovered in inelastic markets. A water or motor carrier, on the other hand, normally operates in a more restricted area and serves fewer markets. If such a carrier is compelled to establish rates below its full costs in some markets, it may not have other, less competitive, markets in which it can make up the deficits. As a result, the motor or water carrier may be forced out of business with its "inherent advantages" destroyed, contrary to the objectives of the National Transportation Policy.²⁷

After *New Haven*, the Commission rarely found reduced railroad rates to constitute destructive competition. It upheld rates covering the railroads' fully distributed costs regardless of cost advantage and regardless of such rates' effect on competitors' traffic.²⁸ Reversing earlier decisions, the Commission approved compensatory railroad rates in the absence of proof that objecting carriers had the cost advantage.²⁹ The agency also approved compensatory railroad rates

27. See *Commodities—Pan-Atlantic S.S. Corp.*, 313 I.C.C. 23 (1960), *revd.*, New York, N.H. & H.R.R. v. United States, 199 F. Supp. 635 (D. Conn. 1961), *remanded to ICC*, ICC v. New York, N.H. & H.R.R., 372 U.S. 744 (1963).

28. In *Volume Class Rates, Transcontinental Territory*, 325 I.C.C. 735, 740 (1965), in which the lawfulness of motor carrier rates covering fully distributed costs was in issue, the Commission said: "[W]e may condemn reduced rates which cover fully distributed costs, including a reasonable profit, only in the most compelling circumstances." Perhaps such compelling circumstances were presented in *New Haven*, in which the Supreme Court said: "To justify such a result [the rejection of reduced rates], we believe it must be demonstrated that the proposed rates in themselves genuinely threaten the continued existence of a transportation service that is uniquely capable of filling a transcendent national defense or other public need." 372 U.S. at 762 (emphasis added).

No case has been discovered after *New Haven* in which the Commission found that railroad rates that returned fully distributed costs constituted destructive competition. See, e.g., *Candy & Confectionery—New Jersey, New York & Pennsylvania to Texas*, 321 I.C.C. 154, 158-59 (1963), in which the railroad had the cost advantage on some services and the water carrier competitors had the cost advantage on others. To the same effect, see *Magazines or Periodicals from Miami, Fla. to Derby-Shelton, Conn.*, 319 I.C.C. 340, 342 (1963); *Alcoholic Liquors from Maryland, New Jersey & Pennsylvania to Florida*, 319 I.C.C. 323, 326-27 (1963). In *Alcoholic Liquors from New Hampshire & New York to Texas & Louisiana*, 319 I.C.C. 396, 398 (1963), *revd.* 315 I.C.C. 124 (1961), the Commission said: "The rates substantially exceed full costs and represent a proper exercise of managerial discretion in seeking to increase volume and revenue." The Commission noted incidentally that the water carrier protestant did not submit evidence to establish cost advantage. 319 I.C.C. at 398.

29. In several cases, compensatory railroad rates were held lawful when protesting motor carriers failed to introduce evidence of their own costs. See, e.g., *Freight, All Kinds, Southern & IFA Territories*, 323 I.C.C. 730, 739 (1965); *Garden Hose & Electric*

when they exceeded the protesting carriers' rates and fully distributed costs³⁰ and when protestants failed to prove that such rates "impaired" their ability to obtain traffic at "profitable" levels.³¹

In *Ingot Molds, Pennsylvania to Steelton, Kentucky (Ingot Molds)*,³² however, the Commission rejected a compensatory railroad rate that was equal to a competing water carrier rate but below the

Cable from New Jersey or Rhode Island to Points in Texas, 319 I.C.C. 227, 229 (1963), *revg.* 314 I.C.C. 515 (1961); Alcoholic Liquors from New Hampshire & New York to Texas & Louisiana, 319 I.C.C. 396, 398 (1963), *revg.* 315 I.C.C. 124 (1961); Aluminum Articles from Sandow, Tex. to Pennsylvania & New Jersey, 319 I.C.C. 431, 444 (1963), *revg.* 314 I.C.C. 453 (1961); Steel Bars from Lemont, Ill. to Iowa, Kansas, Missouri, Minnesota & Nebraska, 319 I.C.C. 292, 306 (1963); Iron or Steel Articles—East to Southwest, 321 I.C.C. 419, 425 (1963), *vacating order of suspension in* 310 I.C.C. 587 (1960); Cement Within Southern Territory & from Hagerstown, Md. to the South, 319 I.C.C. 465, 479 (1963). To the same effect, see *Sea-Land Serv., Inc. v. Baltimore & O.R.R.*, 326 I.C.C. 708, 712 (1966); Cottonseed Oil, Shreveport La., & Texas to Texas Ports, 322 I.C.C. 93, 97 (1964), *revd.*, 323 I.C.C. 698 (1965).

A rate is regarded as compensatory when "it is greater than the out-of-pocket cost of the service for which the rate is set." *American Commercial Lines, Inc. v. Louisville & N.R.R.*, 392 U.S. 571, 578 n.8 (1968). See also note 8 *supra*.

30. See, e.g., *Grain from Idaho, Oregon & Washington to Ports in Oregon & Washington*, 326 I.C.C. 358 (1966), *revg.* 319 I.C.C. 534 (1963). In that case, the Commission said: "Clearly rates may be established at levels below fully distributed costs where, as here, there is a competitive necessity to do so. And where the rates of a proponent carrier are above the rates and fully distributed costs of a competitor we have no basis for concluding that a destructive competitive practice has occurred." 326 I.C.C. at 366. When a nonregulated carrier was a major source of competition, the Commission had approved compensatory railroad rates below the fully distributed costs of another regulated carrier that had the cost advantage and that competed to some extent for the traffic. *Wine, Pacific Coast to the East*, 329 I.C.C. 167 (1966), *affg.* 326 I.C.C. 119 (1965). See also *Grain in Multiple-Car Shipments—River Crossings to the South*, 325 I.C.C. 752, 774 (1965), *affg.* 318 I.C.C. 641 (1963).

31. The Commission apparently considers that a profitable rate is one that covers fully distributed costs. *Sea-Land Serv., Inc. v. New York Cent. R.R.*, 329 I.C.C. 589, 596-97 (1967); *Ingot Molds, Pa. to Steelton, Ky.*, 326 I.C.C. 77, 82 (1965), *revd. sub nom.* *Louisville & N.R.R. v. United States*, 268 F. Supp. 71 (W.D. Ky. 1967), *revd. sub nom.* *American Commercial Lines, Inc. v. Louisville & N.R.R.*, 392 U.S. 571 (1968); *Wrought Pipe to the Southwest*, 319 I.C.C. 310, 317-18 (1963), *modifying* 251 I.C.C. 405 (1942); *Automobile Lamps & Alcoholic Liquors from Pennsylvania to Texas & Louisiana*, 319 I.C.C. 335, 338 (1963); *Magazines or Periodicals from Miami, Fla. to Derby-Shelton, Conn.*, 319 I.C.C. 340, 342 (1963); *Agricultural Insecticides in Tank Cars from Heyden, N.J. to Houston, Tex.*, 319 I.C.C. 493, 495 (1963), *revg.* 315 I.C.C. 623 (1962); *Cereal, Coffee, Tea, Drugs, Related Articles from New Jersey & Pennsylvania to Texas*, 319 I.C.C. 424, 425 (1963); *Candy & Confectionery—New Jersey, New York & Pennsylvania to Texas*, 321 I.C.C. 154, 159 (1963); *Export Grain & Grain Products—WTL to Gulf & Lake Ports*, 319 I.C.C. 729, 743 (1963), *affd.*, 321 I.C.C. 88 (1963); *Pig Iron from Buffalo, N.Y. to Chicago, Ill. & Gary, Ind.*, 321 I.C.C. 121, 128-30 (1963), *revg. in part* 315 I.C.C. 601 (1961); *Plastics from Texas to the East*, 319 I.C.C. 379, 381 (1963); *Electric Cable & Wire from Worcester, Mass. to Houston, Tex.*, 314 I.C.C. 743, 744 (1961), *revd.*, 319 I.C.C. 390 (1963). For cases to the same effect in which railroads protested reduced rates of other railroads, see *Iron Ore, Cleveland, Ohio to Ohio & Pennsylvania*, 323 I.C.C. 746 (1965); *Rail-Water, Grain in Bulk, Missouri, Illinois & Indiana to Buffalo, N.Y.*, 319 I.C.C. 123 (1963), *revd. on other grounds*, 321 I.C.C. 564 (1963).

32. 326 I.C.C. 77 (1965), *revd. sub nom.* *Louisville & N.R.R. v. United States*, 268 F. Supp. 71 (W.D. Ky. 1967), *revd. sub nom.* *American Commercial Lines, Inc. v. Louisville & N.R.R.*, 392 U.S. 571 (1968).

fully distributed costs of the water carrier. In that case, the water carrier had the lower fully distributed costs and the railroad the lower out-of-pocket costs; the Commission found that the railroad was likely to deprive the water carrier of its traffic.³³ Using fully distributed costs as the proper criterion of cost advantage, the Commission condemned the railroad rate as destructive competition.³⁴ The central legal issue in *Ingot Molds*, however—whether fully distributed (fully allocated) or out-of-pocket (variable) costs or neither should be the measure of cost advantage—was not decided by the Supreme Court and remains unresolved.³⁵

B. *The Railroads' Position*

The railroads favor out-of-pocket cost as the criterion of inherent advantage; they argue that fully distributed costs lack rational justification and that the Commission misinterprets section 15a(3) and the National Transportation Policy. According to the railroads, the Commission has failed to explain why fully distributed costs should be the touchstone of inherent advantage or why the mode of transport with the lower fully distributed costs should be considered the more efficient one. They assert that the comparison of out-of-pocket, or incremental, costs is the only rational way to regulate competitive rates.³⁶

Congress, according to the railroads, intended the concept of "inherent advantages" to refer to situations in which one mode of transportation can operate with lower out-of-pocket costs than can others.³⁷ Under the Act, such a mode must be allowed to "assert" its advantage by reducing rates to the level of its out-of-pocket costs, if such a reduction is necessary to obtain traffic. By using fully distributed costs as the standard of cost advantage, the Commission has elevated railroad rates to a level that enables competing modes to obtain traffic at rates covering their fully distributed costs and thus violates the provision in section 15a(3) that rates "shall not be held up to a particular level to protect the traffic of any other mode."³⁸

33. 326 I.C.C. at 80.

34. 326 I.C.C. at 83-85.

35. See notes 42-66 *infra* and accompanying text.

36. *American Commercial Lines, Inc. v. Louisville & N.R.R.*, 392 U.S. 571, 577 (1962). The case for the railroads is most fully and effectively stated in the Baumol articles cited in note 4 *supra*. See also *Ingot Molds, Pa. to Steelton, Ky.*, 326 I.C.C. 77, 78 (1965).

37. *American Commercial Lines, Inc. v. Louisville & N.R.R.*, 392 U.S. 571, 582 n.10 (1968).

38. 49 U.S.C. § 15a(3) (1964).

At the same time, the railroads claim the right to price their services so as to maximize their net revenues, subject to regulatory restraints. These restraints would include requirements that minimum rates not fall below out-of-pocket costs, that maximum rates not exceed reasonable levels to be determined by the Commission, and that aggregate railroad earnings be limited to a "fair return."³⁹

C. *The Position of the Supreme Court*

In *New Haven*, the Commission decided that the railroad rates involved, which had been reduced to the level of competing water-carrier rates and which threatened to deprive water carriers of their traffic, constituted destructive competition.⁴⁰ Because the Commission declined to make a finding on the issue of cost advantage, the Supreme Court reversed;⁴¹ but the Court indicated no preference between fully distributed and out-of-pocket costs as the criterion of cost advantage.

In *Ingot Molds*, the Commission also condemned railroad rates as destructive competition, but explicitly found that the water carrier had the cost advantage.⁴² On review, therefore, it appeared that the Court was directly confronted with the task of interpreting section 15a(3) and the National Transportation Policy. But, surprisingly, the Court held otherwise.

Ingot Molds involved the following facts. From 1953 until 1968, ingot molds were shipped from Neville Island and Pittsburgh, Pennsylvania to Steelton, Kentucky almost exclusively by combination barge-truck service; since 1960 the total charge for the service had been \$5.11 per ton. In 1963, the Pennsylvania and the Louisville & Nashville railroads lowered their joint rate for the same traffic from \$11.86 to \$5.11 per ton. The competing barge lines protested to the Commission that the new railroad rate violated section 15a(3) and the National Transportation Policy because it destroyed the "inherent advantage" of the barge-truck service.⁴³

The Commission made the following findings of fact, which were not in real dispute.⁴⁴ The railroads' fully distributed costs were

39. Baumol, *supra* note 4.

40. *Commodities—Pan-Atlantic S.S. Corp.*, 313 I.C.C. 23, 47 (1960). See discussion of the ICC opinion in note 25 *supra*.

41. *ICC v. New York, N.H. & H.R.R.*, 372 U.S. 744, 760-61 (1963).

42. *Ingot Molds, Pa. to Steelton, Ky.*, 326 I.C.C. 77, 84 (1965).

43. *American Commercial Lines, Inc. v. Louisville & N.R.R.*, 392 U.S. 571, 572 (1968).

44. 392 U.S. at 572.

\$7.59 per ton and their out-of-pocket costs were \$4.69 per ton. The railroad rate was therefore unquestionably compensatory. The fully distributed costs of the barge-truck service amounted to \$5.19 per ton, which was substantially less than the fully distributed costs of the railroads. The barge-truck out-of-pocket costs, although not separately computed, were stipulated to be higher than the railroads' out-of-pocket costs. From the shipper's viewpoint, price was the most important determinant in selecting a mode of transport; but because of service advantages, all the traffic would go to the railroads if the rates were equal.

The Commission decided that the barge-truck movement had the inherent cost advantage⁴⁵ and that the railroads "by reducing [their] rate below the level of the barge-truck full costs . . . [had] unlawfully impinged upon the ability of the barge-truck mode competitively to assert its inherent cost advantage."⁴⁶ The Commission concluded that the railroad rate was "unjust and unreasonable, and in contravention of the national transportation policy."⁴⁷ On review, a three-judge panel sitting in the United States District for the Western District of Kentucky reversed the decision of the Commission, holding (1) that the Commission's order failed to state a rational basis for the use of fully distributed costs as the criterion of inherent advantage and (2) that the order was inconsistent with the congressional intent in enacting section 15a(3), which was to establish out-of-pocket costs as the standard of inherent advantage.⁴⁸

The Supreme Court, in *American Commercial Lines, Incorporated v. Louisville & N.R.R. (Ingot Molds)*,⁴⁹ reversed the decision of the district court and gave directions to affirm the Commission's order. It disposed of the lower court's first holding by asserting that it "must logically follow" the second holding, "since, if Congress in enacting that section had already decided that inherent advantage should be determined by reference to fully distributed costs, there would be no special burden on the Commission to justify its use of them."⁵⁰ The Court then rejected the district court's second holding, declaring that "at the very least, the result reached by the Commis-

45. See text accompanying note 42 *supra*.

46. *Ingot Molds, Pa. to Steelton, Ky.*, 326 I.C.C. 77, 85 (1965).

47. 326 I.C.C. at 85.

48. *Louisville & N.R.R. v. United States*, 268 F. Supp. 71, 75-76 (W.D. Ky. 1967).

49. 392 U.S. 571 (1968).

50. 392 U.S. at 579.

sion here is presumptively in accord with the language of the statute and with the intent of Congress in utilizing that language.”⁵¹

But the Court did not decide that section 15a(3) required the “ICC to use fully distributed costs as the only measure of inherent advantage in intermodal rate controversies.”⁵² The Court said that “[a]ll we hold here is that the initial determination of that question [cost advantage] is for the Commission.”⁵³ It construed the Commission’s finding of cost advantage in the case as “temporary” and declared that the Commission had authority to develop “a general standard of costing to use in determining inherent advantage in situations involving intermodal competition in the broad context of a rule-making proceeding” such as the proceeding that was pending in *Rules To Govern the Assembling and Presenting of Cost Evidence* (Docket Number 34013).⁵⁴ But at least prior to the consummation of that proceeding, the Commission was permitted to use fully distributed costs as the standard for cost advantage.

Justice Harlan, who wrote the majority opinion in *New Haven*, concurred in the result reached in *Ingot Molds* and remarked that the Court “leaves this important question [determining inherent cost advantage] just where our decision of five years ago in the *New Haven* case left it, and new litigation will now be necessary to resolve the issue.”⁵⁵ New litigation may be necessary, but *Ingot Molds* did not leave the “important question” exactly where *New Haven* left it. As the majority in *Ingot Molds* recognized, “[N]othing in the language of the *New Haven* opinion indicates a preference for either out-of-pocket or fully distributed costs as a measure of inherent advantage. . . .”⁵⁶ In *Ingot Molds*, however, the cumulative effect of the Court’s language reveals a preference for fully distributed costs.

In the first place, as noted previously,⁵⁷ the Court stated that “at the very least” the use of fully distributed costs in the case is “presumptively” in accord with section 15a(3). And in the second place, the Court suggested that the use of fully distributed costs is in *some* sense mandatory under the section. Thus, the Court declared that “nothing we say here should be taken as expressing

51. 392 U.S. at 582.

52. 392 U.S. at 590.

53. 392 U.S. at 590.

54. 392 U.S. at 591. Docket No. 34013, *supra* note 3, is discussed in note 18 *supra*.

55. 392 U.S. at 597.

56. 392 U.S. at 583.

57. See text accompanying note 51 *supra*.

any view as to the extent that § 15a(3) constitutes a categorical command to the ICC to use fully distributed costs as the only measure of inherent advantage in intermodal rate controversies."⁵⁸ This language is confusing because "categorical" normally signifies "absolute."⁵⁹ Either section 15a(3) constitutes a categorical—*i.e.*, absolute—command or it does not. It appears reasonable to assume that the Court did not use "categorical" in the word's correct sense, but that it intended to give fully distributed costs *some* sanction as the criterion of inherent advantage.

In contrast with this generally favorable view of fully distributed costs, the Court was consistently critical of the use of out-of-pocket costs, both as a measure of inherent advantage and as a basis for establishing minimum rates for meeting intermodal competition. It characterized the district court's holding that section 15a(3) normally requires out-of-pocket costs to be the standard of inherent advantage as a "fallacy . . . [that] renders the terms 'inherent advantage' essentially meaningless in the context of the language and history of § 15a(3)."⁶⁰ The Court further declared that there was "considerable force" in the argument that "permitting the railroads to price on an out-of-pocket basis to meet competition would result in the eventual complete triumph of the railroads in intermodal competition because of their ability to impose all their constant costs on traffic for which there was no competition."⁶¹ And, after discussing at length the testimony of economists in support of a discriminatory rate structure, the Court concluded: "The simple fact is that § 15a(3) was not enacted, as the railroads claim, to enable them to price their services in such a way as to obtain the maximum [net] revenue therefrom."⁶²

The Commission's "initial determination" of the criterion of cost advantage must now await the conclusion of the rule-making proceedings *Cost Standards in Intermodal Rate Proceedings*, Docket Number 34013 (Sub-Number 1).⁶³ In the original Docket Number

58. 392 U.S. at 590.

59. II OXFORD ENGLISH DICTIONARY 180 (1933 ed.) defines "categorical" as "[a]sserting absolutely or positively; not involving a condition or hypothesis; unqualified."

60. 392 U.S. at 581.

61. 392 U.S. at 585-86. In a discriminatory rate structure, price varies with demand elasticity in order to achieve maximum net revenue. See pt. II. B. 1. *infra*.

62. 392 U.S. at 589.

63. The rule-making proceeding entitled *Cost Standards in Intermodal Rate Proceedings*, Docket No. 34013 (Sub-No. 1), was initiated on February 5, 1969. See note 18 *supra*.

34013, the Commission introduced the terms "variable costs" and "fully allocated costs" to describe the cost levels that had previously been identified as "out-of-pocket costs" and "fully distributed costs," respectively.⁶⁴ Both of these new terms exclude "profit, income taxes, and for railroads, the passenger and less-than-carload deficits."⁶⁵ Since fully allocated costs exclude these noncost elements, they are less objectionable from the standpoint of economic principle than are fully distributed costs. Similarly, the Commission's statement that "'variable costs' . . . is . . . more descriptive [than out-of-pocket costs] of all the unit expenses properly associated with particular changes in output"⁶⁶ indicates that the new concept is an improvement on "out-of-pocket" costs. Because the new and old terms are basically equivalent, the Supreme Court's dicta in *Ingot Molds* favoring fully distributed costs are applicable to fully allocated costs and its criticisms of out-of-pocket cost are applicable to variable costs. It is reasonable to assume, therefore, that if the Commission in Docket Number 34013 (Sub-Number 1) adopts fully allocated costs as the criterion of cost advantage, the Court is likely to approve that decision, at least in the circumstances of *Ingot Molds*. What the Court would do if the Commission reverses its predilection for full costs and decides that variable costs should be the proper standard is more difficult to predict. In *Ingot Molds*, the Court *could* have reasonably found that the issue of inherent advantage was before it, and it *could* have unequivocally affirmed the Commission's use of fully distributed costs. The fact that the Court left the issue undecided pending the Commission's "initial determination" indicates that it might approve variable costs, or even some other conception of cost advantage, if such a standard should be adopted by the Commission.

II. ECONOMIC ISSUES

In determining which criterion of cost advantage to adopt, the Commission and the Court will need to consider the relevant economic issues. These issues can best be dealt with as two separate questions: What criterion of cost advantage is most likely to bring about an efficient allocation of resources? What rate-making principles are consistent with such a criterion?

64. 337 I.C.C. at 324.

65. 337 I.C.C. at 326.

66. 337 I.C.C. at 325.

A. *The Appropriate Criterion*

Three possible criteria of cost advantage—fully allocated costs, variable costs, and marginal costs—require discussion. Fully allocated cost is an inappropriate criterion because it includes an arbitrary apportionment of joint and common (overhead) costs—costs that are not directly associated with the particular services that are in controversy under section 15a(3).⁶⁷ Since these costs are incurred whether or not the services are produced, they do not measure the economic cost of specific services and cannot properly serve as a criterion of cost advantage.

From the standpoint of economic principle, the Commission's conception of variable cost⁶⁸ is almost as objectionable as is fully allocated cost. For, according to the Commission, variable cost—like fully allocated cost—"represents a level of expense which includes, among other things, an apportionment of joint or common expenses which, in fact, are not necessarily incurred as a direct result of a particular movement [of traffic]."⁶⁹ Thus, the only difference between the Commission's variable cost and fully allocated cost is that the latter includes a larger element of uneconomic cost; in principle they are similarly defective.

Marginal cost is by definition free of this economic defect because it excludes any arbitrary apportionment of joint or common costs. Marginal cost may be defined as the additional cost associated directly with the production of the particular service.⁷⁰ Since a carrier does not incur marginal cost unless an additional service is produced, such cost is avoidable. Marginal cost is measured by the value of the additional resources consumed in the production of the additional service. Under a marginal-cost standard, the carrier employing the least valuable set of resources in furnishing services must necessarily be regarded as having the cost advantage.

67. The Commission specifically defines joint or common costs as those "expenses which are incurred on behalf of a production process yielding two or more kinds of output." 337 I.C.C. at 428.

68. The ICC defines variable costs as "unit-costs of output which change with changes in the volume of output." 337 I.C.C. at 428.

69. 337 I.C.C. at 324. Contrary to economic principle, the Commission associates variable costs with a time period that it has not yet determined. 337 I.C.C. at 226. It is difficult to understand the relevance of cost variations over a period of time in fixing rates for particular services. For the economic nature of cost variability, or rather cost elasticity, see Borts, *Increasing Returns in the Railway Industry*, 62 J. POL. ECON. 316 (1954).

70. R. LEFTWICH, *THE PRICE SYSTEM AND RESOURCE ALLOCATION* 148 (rev. ed. 1960).

B. Rate-Making Method

Marginal-cost pricing is obviously consistent with the use of marginal cost as the criterion of cost advantage. It also meets the pricing requirement of welfare economic theory.⁷¹ But marginal-cost pricing in transport would fail to cover full costs, which a carrier must recover in order to stay in business. What is needed is a second-best method of rate-making, one which approximates more closely than any other method the economic advantages of marginal-cost pricing and, insofar as possible, returns full costs. Two methods have been proposed. One provides for discriminatory rates, and the other provides for rates equal to marginal cost plus a uniform increment.

1. Rate Discrimination

While the railroads accept marginal cost as the criterion of cost advantage, they argue for discriminatory rates. They propose that marginal cost "set the lower boundary (and demand considerations and regulation the upper boundary) within which pricing decisions should be made."⁷² Their proposal would refer to marginal cost in order to determine "the specific rate which will provide maximum contribution to the overhead burden and thus to net income."⁷³ This proposal is clearly equivalent to third-degree discrimination designed to maximize earnings.⁷⁴

71. "Welfare economics" has been defined as "the branch of economic science that attempts to establish and apply criteria of propriety to economic policies." M. REDER, *STUDIES IN THE THEORY OF WELFARE ECONOMICS* 13 (1947). The choice of acceptable criteria is the crux of welfare economics. Welfare economics is distinguished from positive economics by the latter's exclusive concern with cause and effect relationships with no attempt to establish criteria for economic policies. J. HADAR, *ELEMENTARY THEORY OF ECONOMIC BEHAVIOR* 14 (1966). For the role of marginal-cost pricing in welfare economic theory, see J. HENDERSON & R. QUANDT, *MICROECONOMIC THEORY: A MATHEMATICAL APPROACH* 206 (1958); A. LERNER, *THE ECONOMICS OF CONTROL* ch. 6 (1944); M. REDER, *supra* at 49; T. SCITOVSKY, *WELFARE AND COMPETITION* 165 (1951).

72. Baumol, *supra* note 4, at 362.

73. *Id.*

74. For the conventional analysis of third-degree discrimination, see J. ROBINSON, *THE ECONOMICS OF IMPERFECT COMPETITION* ch. 15 (1936). This analysis postulates the production of a single homogeneous product (service), a uniform marginal-cost curve, and several markets that are separated according to differences in demand elasticity. Prices differ as elasticity differs, and net revenue is maximized when marginal revenue is the same in all markets. In reality, however, the railroads furnish multiple services, and it may well be that the relevant economic model should include separate marginal-cost curves associated with each of the services rather than a uniform marginal-cost curve. Bailey, *Price and Output Determination by a Firm Selling Related Products*, 44 *AM. ECON. REV.* 82 (1954). For a firm producing multiple products with a uniform marginal-cost curve, the Robinson analysis has been extended by Eli W. Clemens in *Price Discrimination and the Multiple Product Firm*, 29(1) *REV. ECON. STUDIES* 1 (1950-51).

Rate discrimination is not consistent with the use of marginal cost as the criterion of cost advantage, because discriminatory rates are primarily governed by demand rather than by cost. Rate discrimination employs marginal cost merely as a "guide" to maximize net earnings. Under discrimination, the level of rates and differences in rates are admittedly determined by differences in demand elasticity, not by differences in marginal cost. It has been observed that "[b]asing rates on demand (as well as on incremental costs) to attain the maximum contributions means . . . that rates for all services will not be the same either absolutely, or *in relation to cost*, or in contribution to the net income of the carriers."⁷⁵ A rate structure characterized by differences in rates unrelated to differences in cost cannot approximate the economic advantages of marginal-cost pricing.

The railroads, nonetheless, argue that rate discrimination is in both the public and their own interest. Rate discrimination is clearly in the interest of the railroads because it is designed to maximize their earnings. They claim it is also in the public interest because it "can foster more efficient use of railroad resources and capacity and can therefore lower costs and rates."⁷⁶ This claim is of doubtful validity. In the first place, present railroad resources probably reflect excess capacity,⁷⁷ and hence correct economic policy and the public interest require disinvestment rather than increased use. In the second place, no proof is presented that increased traffic will necessarily lower marginal costs, which are the only factor that should be relevant for rate-making. The railroads do not identify the rates that "can" be lowered. It is reasonable to assume that the reference to lower rates relates to rates in markets with inelastic demand and that these rates are therefore high relative to marginal cost. But even if both traffic and net income increase under discrimination, the railroads will not reduce such rates as long as their aggregate earnings

75. Baumol, *supra* note 4, at 363 (emphasis added).

76. *Id.* at 365-66.

On the assumption that the third-degree model applies, it has been demonstrated that discrimination will not *necessarily* lower costs or rates (nor even increase output) as compared with simple monopoly or average-cost pricing. Miller, *Decreasing Average Cost and the Theory of Railroad Rates*, 41 S. ECON. J. 390 (1935). It is clear that the same results follow if multiple products are associated with a uniform marginal-cost curve. And substantially the same results follow if separate marginal-cost curves are introduced. See note 74 *supra*.

77. The wave of recent railroad mergers suggests such excess capacity, since elimination of excess facilities is usually one of the prime objectives of mergers. M. CONANT, *RAILROAD MERGERS AND ABANDONMENTS* ch. IV (1964).

are considered inadequate, and they are likely to be so considered in the foreseeable future.⁷⁸

It may still be argued that rate discrimination is in the public interest because it is good for the railroads and what is good for the railroads is in the public interest. But a discriminatory-rate structure fashioned to maximize railroad earnings may result in a maldistribution of resources. In effect, such a structure imposes a tax on some producers and areas while extending a bounty to others. In this manner it may discourage efficiency in resource allocation and encourage inefficiency. Especially since the railroads do not deny this possibility,⁷⁹ it is clear that a discriminatory-rate structure is contrary to the public interest.

2. Marginal Cost Plus a Uniform Increment

The least objectionable method of fixing rates for particular services subject to intermodal competition is to add a uniform increment to the marginal costs of competing modes of transport.⁸⁰ It can easily be employed in the three situations that differ in respect of cost behavior.

In the situation that is most difficult to deal with from a regulatory standpoint, one mode (*A*) has the lower marginal cost but a competing mode (*B*) has the lower fully allocated cost.⁸¹ Under the proposed method, *A*'s rate would equal *A*'s fully allocated cost and *B*'s rate the sum of *B*'s marginal cost and an increment equal to the difference between *A*'s marginal cost and *A*'s fully allocated cost. Under the policy expressed by the Commission in *Ingot Molds*, *B*'s rate would equal *B*'s fully allocated cost and *A*'s rate would exceed

78. In the decade 1959-1968, the rate of return experienced by class I railroads of the United States ranged from 1.97% in 1961 to 3.9% in 1966. The rate was related to investment after depreciation, the lowest usable rate base. ASSOCIATION OF AMERICAN RAILROADS, RAILROAD REVIEW AND OUTLOOK 7 (1970). More recent trends are even less encouraging. For the twelve months ended September 30, 1970, the rate of return was 1.77%. Association of American Railroads, Information Letter No. 1939, Nov. 4, 1970.

79. Baumol, *Clarification*, *supra* note 4, at 349.

80. J. SARGENT, BRITISH TRANSPORT POLICY ch. 4 (1958); Vickrey, *Some Implications of Marginal Cost Pricing for Public Utilities*, 67 AM. ECON. ASSN.—PAPERS AND PROCEEDINGS, 45 AM. ECON. REV. 605 (1958).

81. This situation is identical to that in *Ingot Molds*, if the assumption is made that the mode having the lower out-of-pocket cost also has the lower marginal cost. Here it can be argued that it would be preferable to set *B*'s rates at *B*'s marginal cost times the ratio of *A*'s fully distributed (average) cost to *A*'s marginal cost. Equal proportionality between prices and marginal cost may be a better approximation to the standard welfare optimum conditions. On the other hand, the uniform increment has the advantage of simplicity.

B's fully allocated cost in a measure calculated to enable *B* at least to share in the traffic. But after *New Haven*, the Commission would not prescribe a rate for *A* above *A*'s fully allocated cost.⁸² In any event, *A* would be barred from establishing a rate reflecting its superior efficiency, which is indicated by its lower marginal cost.

In the second situation, *A*'s marginal *and* fully allocated costs are both lower than *B*'s. The proposal suggested here would be to prescribe rates precisely in the same manner as in the preceding case. In some circumstances it may be desirable to fix *B*'s rate at *B*'s fully allocated cost. In that event, the mode having the lower marginal cost would still have the lower rate, and a measure of flexibility would be afforded. Under the Commission's present policy, *B*'s rate would exceed *A*'s by a margin computed to enable *A* to participate in the traffic at rates covering *A*'s fully allocated costs. Again *B*'s maximum rate would equal *B*'s fully allocated cost; but *B*'s rate would not be designed by the Commission to reflect the measure of *A*'s marginal-cost superiority.

Finally, in the third situation, the two modes' marginal costs are equal but *A*'s fully allocated costs are higher than *B*'s. The addition of a uniform increment to the marginal costs of both *A* and *B* would result in equal rates. Again it may be found preferable at times to provide for flexibility by establishing rates for *A* and *B* at the fully allocated cost of each. But since marginal costs are equal, there is less justification for unequal rates than in the preceding cases. Here again the Commission would require *A*'s rate to be at a level that would enable *B* to obtain traffic at rates covering its fully allocated cost but that would not be above *A*'s fully allocated cost. Such rates would fail to indicate the equal efficiency of the competing modes.

Under a system of discriminatory rates, all that can be said is that marginal cost would serve as the minimum in all three situations. The margin by which the precise rate would exceed that minimum would depend upon the character of the demand for the service. In markets where demand is relatively elastic because of severe intermodal competition, the margin would be small and rates relatively low; in markets where demand is inelastic because of the absence of such competition, the margin would be large and rates relatively high. Thus, rates would reflect neither differences in marginal cost not the relative efficiency of competing modes.

82. See note 28 *supra*.

In all three situations, establishment of rates at the level of marginal cost plus a uniform increment would be consistent with a marginal-cost standard of cost advantage, because such rates would reflect differences in marginal cost. At the same time, the rates would tend to recover full costs. Since such rates would have the additional merit of departing only slightly from the conventional application of full cost in rate-making, they would maintain substantial continuity in the Commission's policy.

III. SUMMARY

The principal legal issue in section 15a(3) rate-making proceedings involving intermodal competition concerns the determination of the proper criterion for calculating inherent cost advantage; the principal economic issues encompass the same search for the proper criterion and also cognate rate-making principles.

The legal issue has been argued before the Supreme Court in two cases, but the Court found both times that it was not necessary to decide the issue, because the Commission had not made an "initial determination" of cost advantage. There is, however, a difference between the relevant dicta in the two cases. In *New Haven*, the Court indicated no preference between fully distributed costs (now fully allocated costs) and out-of-pocket costs (now variable costs) and even said that the appropriate measure of cost advantage "may be" neither.⁸³ In *Ingot Molds*, however, the Court clearly favored fully distributed costs.⁸⁴ It is reasonable to assume, therefore, that if the Commission should make an initial determination in favor of fully allocated cost as the standard of cost advantage, the Court would approve. It is less likely, but still probable, that the Court would approve a determination by the Commission that variable cost is the proper criterion. It is, however, unlikely that the Court would interpret section 15a(3) as a "categorical demand" to adopt either fully distributed costs or out-of-pocket costs, or any other standard.

According to economic principle, marginal cost is the correct standard because it measures the social value of resources used in performing the particular services in controversy under section 15a(3). But simply equating rates with marginal cost is impracticable because such rates would normally fail to cover a carrier's full costs. Discriminatory rates, designed to maximize net income, are not consistent with a marginal-cost standard, because they are governed

83. *ICC v. New York, N.H. & H.R.R.*, 372 U.S. 744, 760 (1963).

84. See text accompanying notes 56-62 *supra*.

primarily not by cost but by demand. Furthermore, they may distort resource allocation and are therefore not in the public interest. Rates calculated as the sum of marginal cost and a uniform increment are consistent with a marginal-cost standard and tend to cover fully allocated costs. Of all practicable proposals, therefore, only this method of rate calculation is consistent with marginal cost as the criterion of cost advantage and is in the public interest.